Where Has All the Volume Gone?

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With the S&P 500 up 34% from its low on March 9, 2009, the market has certainly turned. The big question: Is this a bear market rally, destined to plummet again, or a new bull market that will see a continued rise?

Many investors look at increasing trading volumes as a sign that the market is heading higher. This is based on the traditional premise that when both the market and volume go up, classic buy and hold institutional investors are purchasing stocks and we are in for a rising market.

Indeed, it would appear volume is up strongly. According to Raymond James research, average daily volume (ADV) for US equities was a record 12.3 billion shares in March, exceeding the previous high of 12.2 billion, when the market tanked in October 2008. April ADV was 11.2 billion shares, down 8% from March, but 67% higher than a year ago.

We live in a new world of electronic trading, however. Nowadays, you always have to look beneath the surface to understand what is really going on. In this case, the composition and type of volume we are seeing today has changed dramatically.

Volume is coming from high frequency, algorithmic traders, not buy and hold institutions. These new traders' strategies are based on making a small amount of profit on a large number of small, direct market access trades, involving a large number of companies.[1] According to the Aite Group, they accounted for more than 60% of the ADV in equities in 2008, expected to rise to 70% this year.

For example, look at the March 2009 trading statistics for Investment Technology Group, Inc. (ITG), a leading electronic agency broker. US ADV of 231 million shares shot up 11% from February 2009 and was slightly higher than March 2008, due to switchover to higher frequency traders from institutional investors.

"We saw our full-service institutional clients retrench this quarter subsequent to significant declines in their assets under management, while our direct market access clients increased business with us," said Howard Naphtali, Chief Financial Officer.

Or look at LiquidNet, the leading "dark market" for institutional block trading. March US ADV fell 3.8% year over year.

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[1] See Themis Trading's white paper, "Toxic Equity Trading Order Flow on Wall Street" on our website at http://www.themistrading.com/article_files/0000/0348/Toxic_Equity_Trading_on_Wall_Street_12-17-08.pdf

Institutional block trading has fallen for several reasons:

1. Asset deterioration. A survey by Greenwich Associates found that U.S. investment managers' portfolio assets declined in value by an average 31% in 2008.

2. Mutual fund outflows. Investment Company Institute data on equity mutual funds shows a $25 billion outflow in February and overall redemptions of more than $185 billion since September 2008.

3. Hedge fund redemptions. HedgeFund.net estimates that hedge fund industry assets of $1.724 trillion are 41% lower than their peak in June 2008.

Clearly, the buy and hold, long only equity fund managers have slowed their trading activity. Instead, what we are seeing is high volatility days leading to more high frequency trading and higher volume. In turn, this is confusing traditional investors about the true direction of the market.

All of which begs other questions. What should buy and hold institutions do? Sit on the sidelines until it is clear the next bull market has arrived? That's not likely to get investors excited about moving their growing pile of money market and bank deposits into stocks.

One solution may be what a growing number of hedge funds and traditional institutional investors are doing. They are trading more frequently, to lock in gains on a shorter term basis, according to youDevise Limited. youDevise operates something called the Trade Idea Monitor, which enables institutional brokers to send short-to-mid term equity trading ideas to their clients.

Brokers sent more than 85,000 new trade ideas to their clients during the first quarter of 2009, up 61% from the year ago period. The number of participating firms increased 57%, to an average of 455 institutional brokers and money managers. The time the average idea stayed "open" dropped in half over the last year -- to only 23 days. And the percentage of short ideas increased to 44%, from 39%.

Hang on. It's likely to be a bumpy ride.

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